CENTER FOR ECONOMIC DEVELOPMENT

ECONOMIC IMPACT OF THE REGISTERED PLEDGES SYSTEM IN BULGARIA

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Economic environment and banking system in Bulgaria after 1996

The crisis that swept the Bulgarian banking system in the early 90-ies peaked in the end of 1996 and in early 1997. In May 1996 new legal procedures regulating bankruptcy of private commercial banks came into place. As a result 14 banks, which at the time accounted for almost 24 per cent of the banking sector were placed under special supervision by the Bulgarian National Bank. For the whole period between May 1996 and April 1997 the total number of banks under special supervision reached 18, and this meant that effectively a third of the banking sector in Bulgaria was closed down. Out of 27 private banks that existed at the time the four largest and most popular ones were placed on the list of institutions under special supervision. In addition, the banking supervision authorities took a number of measures that affected 19 banks and included:

- Ban on dividend payout without prior authorization by the Bulgarian National Bank
- Ban on any new lending activities
- Measures to collect loans given out to borrowers
- Limiting interest rates offered by the banks and reduction of their operating costs

Bulgaria had suffered the worst financial crisis since the beginning of market economy oriented reforms; a crisis that was characterized by paralyzed banking system, shattered trust in major institutions, significant devaluation of the national currency and a period of hyperinflation (December 1996 – February 1997).

To overcome such a crisis a combination of economic measures that affect exchange rates, monetary supply, the national budget, and so on was needed. The purpose of those measures was to restore trust in the financial sector and to bring about macroeconomic stability.

Eventually, the idea of introducing currency board in Bulgaria as a part of the above-mentioned measures was adopted. The main instruments of a currency board include fixed exchange rate of the national currency, balancing the state budget as well as providing independence of the country's central bank from intervention into its activities.

The introduction of the currency board presented a great challenge to Bulgarian

commercial banks; they had to radically change their behavior to survive the grim reality. Some of the factors that forced the changes were:

- A very limited ability to use lenders of last resort. Under a new set of very strict rules the Bulgarian National Bank could only give small but highly secured credits to solvent banks that had temporary liquidity problems
- The introduction of restrictive rules and regulation needed to manage and control the banking system
- Strict supervisory policies
- Very high requirements for bank solvency
- Eradication of high risk unsecured credits

As a result of the devaluation of the Bulgarian lev and the short period of hyperinflation the market capitalization of the banking system improved considerably since 1997. The devaluation of the national currency provided the banks with the opportunity to restructure their portfolios and to clean up their balance sheets. The main factor for the re-capitalization of the banks was the appreciation of their assets denominated in foreign currency, relative to the decrease in real value of their liabilities, denominated in levs.

At present the Bulgarian banking systems consists of 35 banks which are split into 5 separate groups according to their balance-sheet figure[1]:

Group one consists of three banks: Bulbank, DSK Bank and United Bulgarian Bank; whose balance-sheet figure exceeds 800 million levs and they have provided over 35 per cent of credit resources available to non-financial institutions;

Group two consists of seven banks: Commercial Bank Biochim, Bulgarian Post Bank, SG Expressbank, First Investment Bank, Raiffeisenbank, Hebrosbank, and BNP-Paribas; whose balance-sheet figure is between 300 to 800 million levs and they have provided approximately 33.4 per cent of credit resources available to non-financial institutions;

Group three consists of eight banks: Roseximbank, Economic and Investment Bank, Municipal Bank, Central Cooperative Bank, HypoVereinsBank, Commercial Bank Bulgaria Invest, Eurobank and Bulgarian American Credit Bank; whose balance-sheet figure is between 100 and 300 million levs and they have provided 14.9 per cent of credit

[1] *Data from BNB as of 30.09.2002*

resources available to non-financial institutions;

Group four consists of eleven banks: Unionbank, Neftinvestbank, Corporate Commercial Bank, First East International Bank, Demirbank, International Bank for Trade and Development, Tokuda Credit Express Bank, Encouragement Bank, Commercial Bank of Greece, ProCredit bank and PEB Texim; whose balance-sheet figure is up to 100 million levs and they have provided 6.7 per cent of credit resources available to non-financial institutions;

Group five consists of the branches of six foreign banks: ING Bank, Citibank, National Bank of Greece - Sofia Branch, Pireos Bank (former Xiosbank), Alpha Bank and Ziraat Bankasi; who have provided a little under 10 per cent of credit resources available to non-financial institutions;

The slowdown in the growth of the global economy and the effects of the process of globalization strengthened some of the negative trends in the financial environment of countries with transition economies. The lower rate of growth of the Gross Domestic Product in most parts of the world coincides with a sharp fall in the rate of growth of foreign trade, considerable decrease in investment and slowing consumer spending. In Bulgaria GDP rose by 4.7 per cent in 2001 as opposed to 5.8 percent in 2000. Growth is highest in the field of industry, where the gross added value has increased by 15.3 per cent, followed by the service industry, which grew by 7.8 per cent. In 2000 the agricultural sector shrank by 10 per cent, and in 2001 it shrank by yet another 8 per cent[2].

The high exposure to raw materials and semi-finished materials of the Bulgarian foreign trade makes the country vulnerable to global changes in economic activity, especially because fluctuations in the prices of semi-finished materials are much higher than these of goods with a higher degree of processing.

[2] *Sources: BNB, MF, NSI;*

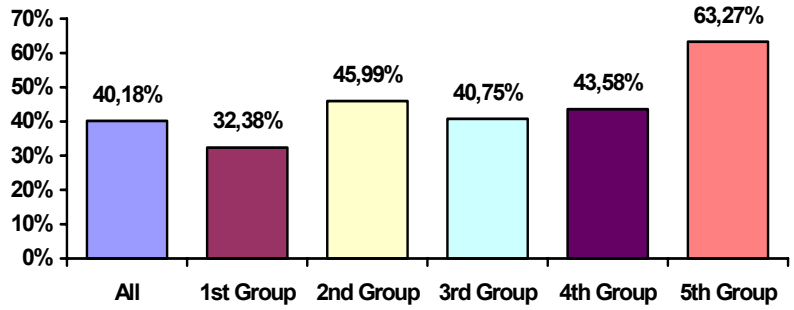
Development of the Bulgarian credit market in recent years

The emergence and development of banking is fundamentally related to the granting of credit, the associated credit risk, and the trust of lenders and borrowers. As a rule banks provide a fairly large amount of credit resources to borrowers and represent the largest lenders to businesses in the economy. Banks generate profits through the interest rate they charge on a credit, which is in fact the price borrowers have to pay for the credit. The amount charged as an interest is generally many times smaller than the credit amount. When agreeing on the conditions of a credit, both parties involved – the lender and the borrower – have to decide on an acceptable level of credit risk. In order to evaluate the risk associated with a given credit transaction, one has to identify the credit specifics, the associated credit risk, any risk factors that influence it and to establish the relationships that exist among them.

A credit is any financial claim that arises from a bank loan agreement; from a line of credit; from the acquisition, acceptance, or grant on a bill of exchange; from the endorsement of bills of exchange, promissory notes, securities or other negotiable instruments; from transfer of receivables; from credit facilities in the form of deferred payment, payment in installments, extended grace period, reduced rate of interest, etc; from advance payments; from the establishment of a letter of credit; from a standby letter of credit; from overdraft facility on a bank account; as well as from all other types of receivables irrespective of the type of financial instrument involved.

The share of total amount of credits loaned by Bulgarian banks has increased to way above 30 per cent of their total assets in recent years (40.18% by the end of September 2002). This ratio varies across the five different groups of Bulgarian banks listed above. This share is the smallest in the first group of banks – 32.38%, and the highest in the fifth group – 63.27%.

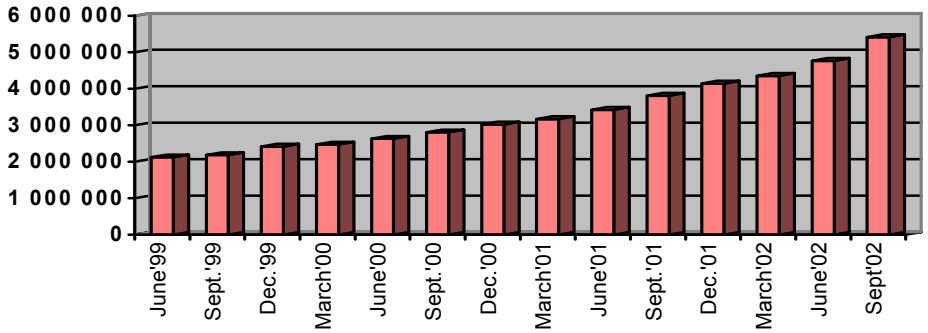
Chart 1. Share of credits as a percentage of total assets of Bulgarian banks



The chart above represents the actual distribution of the credits/(total assets) ratio among the five groups. The almost twice-bigger number for the foreign banks can be explained with their experience and attitudes on the world markets. Their management abroad is more flexible and missed the bad experience of the Bulgarian banks during the crisis of '96-'97.

The total value of credits to non-financial institutions and other clients of the banks by the end of September 2002 is 5 414 813 thousand BGN. Chart 2 shows the positive trend of the total volume of credits granted by Bulgarian banks.

Chart 2. Total volume of credits granted by Bulgarian banks (thousand BGN)



The quarterly results for the past three years prove that the banking system in Bulgaria is overcoming the critical moments after the '96-'97 crisis and the macroeconomic stability is providing for overall performance of the banking sector, which is closely related to the development and prosperity of the private companies in the country.

The credit practices of the Bulgarian banks are geared to provide low-risk credits to companies that have proved their ability to operate and to grow in the present economic environment in the country.

The maintenance of a balanced credit portfolio brings about liquidity and positive balance of the bank's capital.

Chart 3. Credit portfolio of Bulgarian banks (thousand BGN)

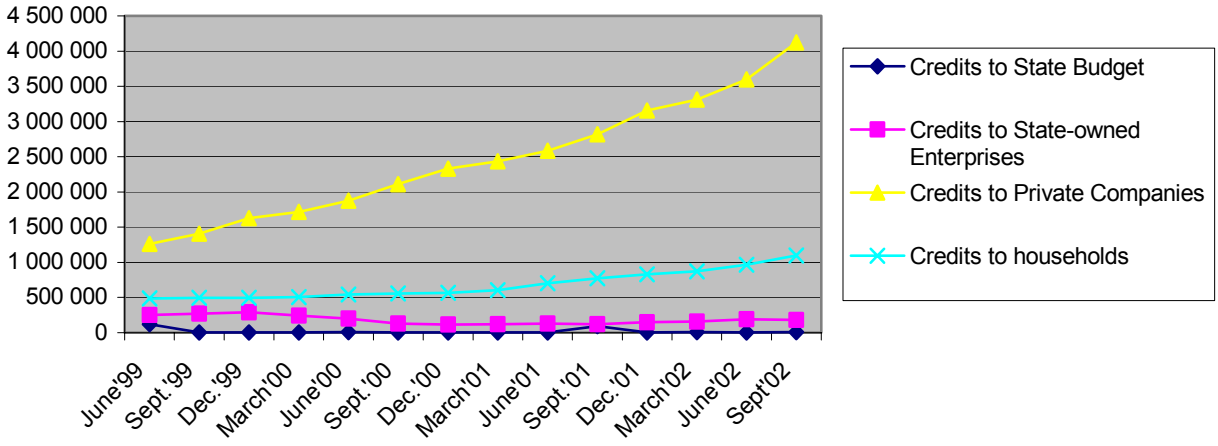


Chart 3 clearly exhibits the strong positive trend in the growth of credits to private companies over the same period of three years (from June 1999 to September 2002), as well as the not so rapid, but stable increase in credits to households.

This is indicative of the gradual transformation of the Bulgarian economy into a balanced market economy and the reemergence of lending of capital as the one of the basic activities of commercial banks.

The total credit volume is several times below the value[3] it used to have prior to the bank crisis of '96-'97, but the observed positive trend is most likely to continue if there are no major economic shocks worldwide.

The use of pledges of property as an alternative way for securing a debt by means of providing an equal in value and liquid collateral and their role as a factor that minimizes the risk associated with a credit have made pledges a necessary component of the credit agreement. The Law on Registered Pledges facilitates the need for a system of legislative mechanisms that regulates the credit risk related to pledges of property. The law provides a solution to a major problem that has long obstructed market reforms in Bulgaria. It addresses the issue of securing a debt or a credit, which is, in turn, related to the risk of

[3] The credit capacity of the banking system shrank about four times after the 96/97 crisis (measured as a share of GDP). (see "Credit Activities of the Commercial Banks and rationalizing of the Credit Market in Bulgaria", K.Hristov, M.Mihaylov)

failure to collect property pledged as a collateral. This is of major importance to banks that as a rule use capital deposited by individuals and/or juridical persons.

The deposit and lending activities of a bank create a constant level of risk associated with its operations.

The Law on Registered Pledges may be considered as a special defense mechanism for the credit activities of the banks (it has predominantly supervisory and control functions). It protects the rights of the creditor and oversees the security provided by the debtor. This is carried out by the procedure of recording the pledge in a Central Pledge Registry, which has been established for the purpose. The aim of the law is to provide creditors with protection against credit risk.

Credit risk is a basic component of a credit that represents the probability of the debtor to default on or to be otherwise incapable of fulfilling the credit agreement. Credit risk management is vital to the performance of a credit institution. The income of banks results from their credit and investment activities. The main objective of the banks is to balance the potential income with the risks associated with it. The risks associated with banking, like risks associated with any other type of activity, cannot be eliminated completely; it can only be reduced and diversified.

The most common example of credit risk is the failure of the borrower to repay the credit. The credit exposure of a bank contains a number of credit facilities, i.e. different types of credit, bank guarantees on good performance, on cash advances, on grants of bills of exchange, and many others.

The credit risk is a component of all assets on a bank's balance sheet (including off-balance-sheet products) and is comprised of two basic elements: the risk of non-fulfillment of obligations by the borrower (the contractor), and product risk.

The risk of non-fulfillment of obligations by the borrower (the contractor) can be divided into:

- Clients risk – the inability or refusal of the client to settle the debt. This type of risk falls into the category of pre-contractual risks. A successful way to minimize them is to form a portfolio of buyers in the case of a product that can be sold to more than one buyer. If one of them refuses to pay for the product there is still another buyer for it.

- Country risk – arises from the probability that all or almost all economic entities (including the government) in a given country cannot meet their obligations on international credit agreement due to some economic or other factor internal to their country of origin. An example of this type of risk is the failure of a number of Latin American governments to service their foreign debts.
- Transfer risk – results from the inability or refusal of a country's economic entities to service international financial obligations due to lack of foreign currency in which these obligations are denominated. This situation may take place even when entities are solvent within the limits of the country's currency.
- Concentration risk – arises from the concentration of credit facilities in a specific economic fields or regions that experience difficulties, as a result of which the creditor may incur significant losses.

The product risk is related to the structure of a credit deal and is comprised of currency risk, interest rate risk and security risk.

Currency risk is the probability that a financial gain or a loss may result from the fluctuation in exchange rates for different currencies, including the exchange rate for the national currency. This type of risk is present in a number of foreign economic and credit operations, as well as in investments in foreign economies. All participants in a country's economy are subject to currency risk because of the fluctuation in the national exchange rate and the corresponding change of interest rates.

Interest rate risk is the probability that the rate of interest on deposits may become higher than the interest rate of credits already given to borrowers. The interest rate risk has an effect not only on the income from interest on credits, but on the overall balance of the credit institution. Frequent changes in the rates of interest bring about uncertainty for both creditors and borrowers. The inability to forecast the rate of interest with a certain degree of certainty has a negative effect on the planning of business activities. A rise in the interest rate on a credit can seriously disrupt cash flows within an organization. Methods to limit the uncertainty in forecasting future interest rates can be used to significantly reduce the interest rate risk, which is a major obstacle to business and

investment planning.

The security risk is associated with the possible depreciation in value of the assets used to secure a credit. Fall in market prices or decline in the quality of the assets, pledged as security, will increase the security risk associated with them.

Other factors that may influence the security risk are the method of storage and of use of the pledged property. A common practice used to minimize the security risk is to have a higher margin between the amount of the credit and the value of pledged property and to insure the property against the commonly accepted in trading practices types of disasters.

Financial institutions and banks in particular follow very strict rules with regard to the analysis and assessment of risk associated with their most profitable but at the same time riskiest operations – the credit deals.

Periodically, banks reevaluate their risky assets, including the off-balance-sheets commitments, and plan a number of provisions to avoid the risk of financial loss, these provisions are based on criteria set up by the Bulgarian National Bank pursuant to *Regulation 9 on the Evaluation of Risk Exposures of Banks and the Allocation of Provisions to Cover the Risk Related Thereto.*

Regulation 9, which is currently in effect, classifies as "risk exposures" all loans and other claims of a bank reported as balance-sheet items, regardless of the ground for their occurrence and the financial instrument used, for which there is a risk of reduction in their book value, as well as contingent liabilities of a bank, reflected as off-balance-sheet items.

The result of the analysis and assessment of an account is its classification in one of five possible categories, which are: standard, watch, substandard, doubtful and loss.

The way a credit is serviced by the borrower determines the values in the matrix to be used for classification of credits on individual risk exposures.

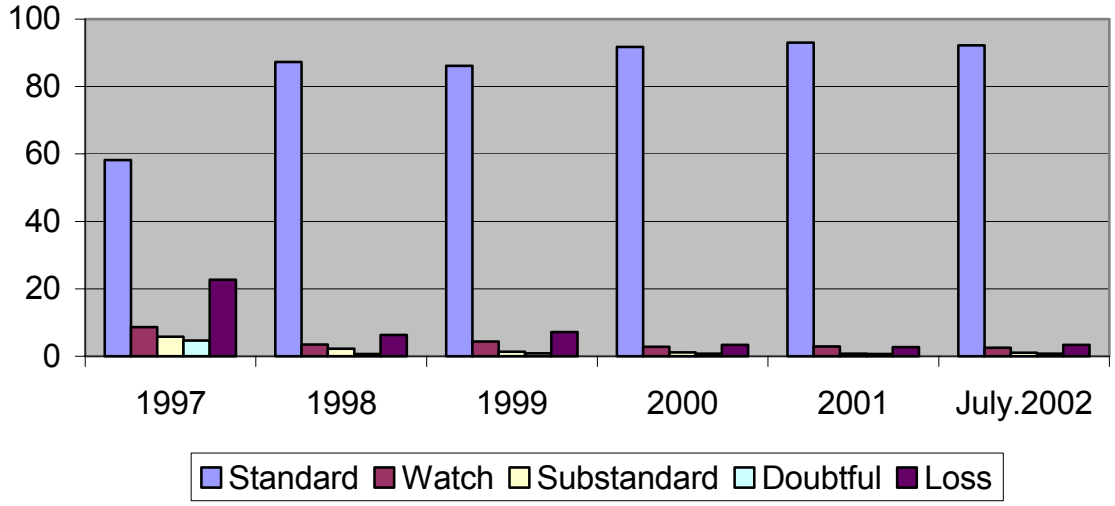
Table 1. Credit classification

Financial standing of the borrower	SERVICING OF THE CREDIT				
	good Up to 30 days	average 31 to 60 days	average 61 to 90 days	poor 91 to 180 days	poor over 180 days
1 category	Standard	Watch	Substandard	Doubtful	Loss
2 category	Watch	Substandard	Doubtful	Loss	Loss
3 category	Substandard	Doubtful	Loss	Loss	Loss
4 category	Doubtful	Loss	Loss	Loss	Loss
5 category	Loss	Loss	Loss	Loss	Loss

The financial standing of the borrower is evaluated by a set of various indicators and is classified in one of the five categories (from one to five). Whenever these indicators fail to classify the borrower in a single category, it is placed in the higher risk category.

Chart 4 represents percentage of credits that are allocated among the five categories. The problems experienced by Bulgarian banks in 1997 are seen on the graph - more than 20% of the granted credits were categorized as "LOSS", with less than 60% of the total credit volume qualify for "STANDARD". In comparison, the share of "STANDARD" credits as of July 2002 is 92.22% and only 3.41% "LOSS".

Chart 4. Credit characteristics of the granted credits



The risk in banking is related not only to the specifics of the credit deal, but also to the present financial circumstances of the borrower. Credit risk assessment requires that the principal risk factors are identified together with the relationships that exists among them. An important way to limit credit risk is to work out the credit rating for the individual borrower by applying a matrix-based assessment used to determine its creditability. The

results of the assessment are based on a points rating, formed from a set of factors with different weighs and predefined coefficients.

A number of agencies and specialized institutions prepare credit rating analyses. The most famous and most authoritative ones are Moody's and Standard&Poor's.

Banks create a number of provisions (table 2) to cover the risk of loss against any given risk exposure, which has been classified under one of the five categories. These provisions are included as accounting expenditures and lack of them results in a decrease in the own capital of the bank, which is reflected in the capital base and capital adequacy of the bank. According to the National Accounting Standards, the amount of necessary provisions is an item of accounting expenditures and an adjustment for the book value of assets. In this way the balance sheet represents the real state and the quality of the bank's assets. The accurate representation of the provisions that have been put aside, banks calculate the so-called "net value of the risk exposure". This is the difference between the principal and the value of a "risk-free collateral".

Pursuant to Regulation 9 issued by the Bulgarian National Bank, risk-free collateral are those listed in Paragraph 1, Article 2 of the supplement to Regulation 9[4].

Table 2. Provisions according to Regulation 9

Category of the account	Specific provisions
Normal	Up to 3%
Watched	From 15% to 25%
Substandard	From 30% to 50%
Doubtful	From 50% to 75%
Loss	100%

[4] *According to this regulation "Risk-free collateral" includes:* cash and deposits with a bank in levs or foreign currency, for which the Bulgarian National Bank quotes an exchange rate every business day; monetary gold; securities and guarantees issued by the government of the Republic of Bulgaria; securities and guarantees issued by governments, central banks and international organizations specified in Appendices Nos. 1 and 2 of Regulation No. 8 of 1997 on the Capital Adequacy of Banks (published in the State Gazette, issue 62 of 1997; amended, issue 92 of 1997); eighty percent of accepted bank guarantees with a term of up to one year; half of the fair value of a fully insured real estate in the country on which first mortgage has been established and which is located in a residential, administrative, trade or hotel building, provided the real estate is easily marketable; insurance policies up to the amount of the insurance cover, signed at the expense of the government under the Law on Export Insurance, where the bank is the insured person or the third-person beneficiary.

Securing of Credit Transactions

In order to guarantee the receivables on a credit and to protect their rights as creditors banks pursue credit policies whose aim is to ensure that credits are secured with a large variety of equal in value and liquid collaterals. As an exception of the rule a bank may choose to grant an unsecured credit to long-term clients with high credit rating, given that the managerial and the internal control department approve the transaction. But in just about any other case banks insist on securing credits in order to minimize the subsequent credit risk.

When analyzing assets that have been offered as a collateral to a credit they look for a proof of the following:

- The right of ownership on the asset by the potential borrower;
- The real value of the collateral used to derive the margin on the credit;
- The liquidity of the asset offered as a collateral in order to determine how easy it is to get its monetary equivalent.

Collateral (security) on a credit is any form of warrant, guarantee, pledge, mortgage or other statement which, in the case of non-payment of on the part of the borrower, can be used by the creditor to collect the outstanding amount of the credit either from the guarantor of by selling the pledged or mortgaged property. The type of collateral is mutually agreed upon by the creditor and the borrower and is recorded in writing in the credit agreement. Independent experts periodically recalculate the value of the collateral in order to establish its market value at that time, so that it can be easily disposed of if necessary.

The cost of provisions, always considered in the process of the risk assessment, is directly related to the type and value of the collateral, and is calculated as a percentage of the net value of the exposure. Therefore the book value of a bank's assets has to be reduced by the sum of the amounts of different types of collateral times a discount factor.

The system for assessment of collateral is often subjective and is guided by the following considerations:

- Higher liquidity of the given collateral and circumstances that allow to dispose of it in a short period of time;

- Good material condition of the collateral, storage conditions that preserve its quality and right to dispose of it if necessary;
- Collateral that is equivalent to the amount of credit; one that can be disposed of at current market value to cover the outstanding debt;
- Availability of insurance on the assets accepted as a collateral;
- Certification of the collateral (e.g. notarization)
- Assessment of the collateral by independent valuation experts.

The assessment of the collateral is done by independent valuation experts hired either by the bank or by the borrower, or, alternatively, by bank personnel, in order to determine its present market value. This market value is periodically updated so that in the case of forcible execution the collateral can be sold on the local markets without further complications and within a time period set by the bank. Banks require that the collateral is exclusive, i.e. it is not used as a security for other credits, mortgages or claims that have a higher or equal priority to their claim.

Banks accept types of security that are known to have an alternative means of fast and unimpeded disposal on the market at a price that provides the required returns. Various standards and the accompanying definitions of terms are used by the banks in the process of assessing assets accepted as a collateral in order for a "fair market value" to be established for these assets. Fair market value is the cash or other monetary equivalent for which a transaction between a seller, who wishes to sell at this price and buyer who wishes to purchase at this price takes place, whereby both parties are well informed of the object of the transaction and given that neither party is in a state of duress to perform this transaction.

Bulgarian banks have also accepted the terms and definitions of the International Accounting Standards, which are related to the valuation of assets used as collateral:

- Any assets to be evaluated must be installed, operational and represent an integral part of the assets of a company
- Assets must be continually used in accordance with their intended use
- The owners of the assets to be evaluated receive economic benefits from them
- The residual value of a pledged asset is the net sum of the value the

creditor expects to obtain for it at the end of its useful existence and the cost of taking of this asset out of operation

- An active market must be in place where buyers and sellers can trade these assets any time and at prices well known to the public

When evaluating assets to be used as collateral for a credit it's obligatory to apply the "Method of liquidation price". This method may also be regarded as a special case of the method of net value of assets, applied to assets under liquidation. The method of liquidation price attempts to find the most likely selling price of these assets.

The selling price depends on the time it takes for the liquidation procedure to be prepared and executed.

Subject to the level of indebtedness of the company different approaches are used to determine:

- Regular liquidation price
- Accelerated Liquidation price

The liquidation price in an accelerated liquidation procedure is the price at which a given asset can be auctioned without any previous preparation, i.e. "as it is and where it is". The liquidation price of the asset is generally low and isn't at all good for the owner of the asset. In order to achieve the regular liquidation price on an asset a transaction has to take place 3 to 6 months after the liquidation procedure has begun.

Usually the final price of assets is a weighted average of the prices estimated through different valuation methods. If an asset is used as a security on a bank credit the value derived from the method of liquidation price is always taken into consideration in its valuation.

When using long-term tangible assets as a collateral to a credit, valuation experts, normally appointed by the bank, assess their present state and availability. It's advisable that during evaluation these assets are in operation. Observations and conclusions are based on the experts' opinions. In the process of identification they need to establish:

- The actual condition of the assets;
- The level of technological obsolescence and of aging due to technological progress;
- Technical and functional maintenance.

To certify the right of ownership of real estate and other fixed assets, banks analyze the ownership deeds of land and buildings (property deeds, acts of public ownership, plots, etc). To certify the right of ownership of chattel and of machinery and equipment, the contracts for multiple and individual deliveries of machinery and technological equipment as well as primary accounting documents (invoices) are reviewed. All long-terms assets which have been used as a security for a credit are must be insured by and at the expense of the borrower on behalf of the bank for any insurance risks that cover the total amount of the credit and the security margin. Insurance risks must be covered for the full period of the credit and also for an additional advisory period to allow for a possible delay of repayment or for a possible forcible execution procedure.

Types of collateral preferred by credit institutions

Members of a market oriented society require reliable guarantees in order to be able to actively participate in the credit market, while at the same time a system that can balance the interests of both borrowers and lenders and can prevent possible obstructions or even a breakdown in the flows of tangible and financial assets facilitated by this market is needed.

Commercial banks favor certain types of collateral:

- Legal mortgages and mortgage contracts
- Pledge of movables
- Pledge of cash receivables denominated in the national and/or foreign currency
- Pledge of shares of equity and other securities
- Guarantees by solvent third parties on behalf of debtors

A pledge of a piece of real estate property can either be a legal mortgage or a mortgage contract; in either case it is instituted by recording the facts of the mortgage in notary books used specifically for the purpose, which are kept by the District Court at the local Notary offices.

Pursuant to Article 43 of the Law on Banks, the bank (the creditor) entitled to a legal mortgage on real estate and property rights thereto acquired entirely or partially through the use of a bank credit, whereby the mortgage is created by recording the outgoing mortgage application in the notary book of the local Notary office. A mortgage contract is created in the form of a notary deed and is effected from the time of recording in the notary book of the local Notary office. Both the legal mortgage and the mortgage contract are lawful provided that all relevant information pursuant to Article 167, Paragraph 2 has been provided with reference to Article 170[5] of the Law on Obligations and contracts.

[5] Article *167.* A mortgage contract shall be concluded with a title deed.
It shall indicate: the full names, domicile and occupation of the creditor and the debtor, as well as of the owner of the property if the mortgage is created for another's obligation, and if any of the above parties is a legal person -- its trade name; the property on which the mortgage is created; the secured claim, its maturity and the interest rate if interest is agreed, as well as the amount for which the mortgage is created if the claim is non-monetary.
A mortgage may be created only on property which belongs to the mortgagor at the time when the contract is concluded.
Article *170.* The creation of a mortgage shall be invalid if either in the mortgage contract, in the application for creation of a mortgage by operation of law, or in the deed pursuant to which it is filed there is uncertainty as to the identity of the creditor, the owner or the debtor, the identity of the property and the secured claim, or the amount of the sum for which the mortgage is created.

When a number of individuals hold joint ownership in a real estate property, it can be mortgaged as one piece of real estate given that all the co-owners are constituted as mortgagees.

When, as an exception of the rule, it is decided to mortgage a share of the property, the borrower must obtain the agreement of all co-owners of the property.

Banks choose not to accept temporary structures or buildings built in breach of the Law on Territorial and Settlement Structure and the regulations that implement it.

The market value of the mortgaged property must exceed the value of the principal of the credit, while its security margin is based on the duration of the credit.

Pledge of chattel and receivables, including inventory, stocks, goods in production, transported goods and goods in turnover is created pursuant to the Law on Registered Pledges, the Obligations and Contracts Act and Regulation 35 by the Ministry of Finance and the Ministry of Justice. The pledge may also be supplied to bona fide third parties given that the registered pledge agreement is officially dated and certified. When pledging processed goods and materials the pledgor has the right to continue to process the pledged items, in which case the pledge is transferred to the newly created inventory, and the receivables from it, the inventory can then be sold under an agreement with the bank. When pledging goods in turnover, under a special agreement with the bank the pledgor may collect the proceeds from the sale of the goods, in which case the pledge is transferred to the receivables from the pledged goods. Chattel, pledged as security to a loan, can only be reclaimed if an equivalent payment is made to settle the debt in accordance with the existing debt repayment plan.

A bank would normally select only certain types of goods as a registered pledge; these goods must have relatively constant prices, which are quoted on commodity exchanges or otherwise easy to establish market prices, there must has to be a steady demand for them and they must be easily sold. Regardless of the type of pledged security, the bank may choose to leave it with its original owner or a third party in which case the credit agreement and the relevant form for responsible keeping list the rights and responsibilities of the keeper and the particular person in charge of the company's property. The value of a pledge can decrease and pledged items can be reclaimed given that the pledgor has repaid the principal on the credit and the corresponding part of the

interest, which is again subject to contract.

When accepting pledged property the bank will require documents that prove the ownership of all pledged goods and items (i.e. invoices, bills of entry, certificates of origin, wills, etc.). In the absence of these documents the pledgor is required to provide a written statement to confirm ownership of the pledged property, which is used to certify that the borrower is accountable under the law if any information provided is untrue. All goods and items that have been pledged to the bank are listed in great detail in the pledge, credit or mortgage agreement in order to make them legally separate and specifically determine possible disposal activities with regard to them. In all cases the pledgor meets the costs of creating a registered pledge for a credit, including the local and state taxes and duties.

It is mandatory to insure any pledged fixed and other assets on behalf of the bank. If the borrower has already insured the property in question, the bank required that the receivables and other proceeds from the insurance be transferred on its behalf. The bank may require a more comprehensive insurance of the property if there are specific requirements in the credit, mortgage or pledge agreement.

Insurance risks for the bank must be covered for the total time of the credit together with the additional period of time to allow for a possible delay of repayment or for a possible forcible execution procedure.

The pledge of securities, which include government securities with one-year maturity; stocks and bonds issued by the state, municipalities and local commercial companies is registered by the bank in accordance with the legal requirements in place for every type of security.

The pledge of bonds and shares of commercial companies is accepted by the bank given that this does not contradict the statute or any other acts of the issuing company restrict them from being transferred to third parties.

As an additional guarantee, and based on the invoice value of the transported goods, the bank may accept the pledge of documents that identify the pledgor as an owner of transported goods (a bill of lading and other documents: contracts, invoices, etc. related to a specific deal); the related registered pledge agreement records the transfer of the transported goods on behalf of the bank.

Pledge of cash receivables denominated in leva and in foreign currency owned by the pledgor or third parties is also accepted as collateral by banks

1. Receivables on a foreign currency deposit contract. This type of pledge is only accepted if the deposit is with the bank and after a detailed study of the trends of the exchange rate of this foreign currency relative to the lev and on the international currency markets
2. Receivables on a deposit denominated in Bulgarian levs. In this case the credit agreement specifically requires that the account is frozen for the duration of the credit

Whenever a deposit in a different bank is pledged the pledgor signs an agreement pursuant to Article 18 of the Regulation on Noncash Payments and the National Payment System, which allows for immediate collection of the deposited funds.

The bank would normally accept a registered pledge of receivables from a grant on a bill of exchange issued by banks or other solvent entities, which have been created and are collectable under the existing legislation.

To secure a credit banks may also accept guarantees from other Bulgarian and foreign banks. Guarantees from foreign banks are accepted after their crediting potential has been evaluated and if they are considered in to be compliance with the international and national legislature.

Registered pledges. Law on Registered Pledges

The Law on Registered Pledges addresses the issue of securing debts (claim), which is, in turn, related to the risk of failure to collect pledged receivables. This issue is of particular interest to lending institutions that operate with borrowed capital. The Law on registered pledges confirms the rights of creditors (pledgees) to have a secured interest in property owned by debtors (pledgors), while allowing debtors to retain possession and use of the property, object of the pledge, i.e. the law institutes a pledge that is established without the delivery of the pledged property. The debtor has the right to dispose of any pledged property as long as this is of interest to their normal business activity while at the same time all rights of the pledgee on the pledged property are guaranteed by law.
The main characteristics of a registered pledge are:

- Written form of the pledge agreement as a requirement for its validity.
- The pledgor shall be either a merchant or a person, pursuant to Article 2 of the Commerce Act (Par. 3 of the Law on Registered Pledges).

According to Bulgarian Law on Registered Pledges, the property that may be pledged is as follows:

- **Accounts receivable and groups of accounts receivable**
- **Uncertified securities and groups of uncertified securities.**
- **Chattel exclusive of ships and aircraft**
- **Groups of machines and equipment, of goods and materials**
- **Entity shares in general and limited partnerships, limited partnerships with shares or limited liability companies.**
- **Commercial enterprise**

All of the facts required by the Law on registered pledges to be filed to record a pledge of a commercial enterprise, shall be recorded in the pledgor's record in the Commercial Registry. A secondary entry is made in the Central Pledge Registry based on a copy of the certificate for entry from the Commercial Registry.

The Central Pledge Registry registers pledge agreements where the pledged property is as follows:

- Accounts receivable and groups of accounts receivable;
- Chattel exclusive of ships and aircraft;
- Groups of machinery and equipment, or of goods and materials;
- Commercial enterprise - after the entry in the Commercial Registry;

All of the facts required by the Law on registered pledges to be filed to record a pledge of uncertified securities, shall be recorded in the Central Depositary. State securities shall be recorded in the State securities registries.

All of the facts required by the Law on registered pledges to be filed to record a pledge of equity shares, shall be recorded in the record of the issuing company in the Commercial Registry.

The procedure of entry of the pledge agreement in the Central Pledge Registry is needed in order for a pledge to be perfected as to the interests of third parties with respect to their rights in the pledged property, subject to the pledge agreement.

The entry in the Central Pledge Registry is not required under the pledge agreement procedure.

The pledge agreement is created at the moment of signing of the agreement (by the interested parties).

The Law on Registered pledges and the Commerce Act govern the procedure of creating a pledge agreement. A registered pledge can be set up by merchants or persons other than merchants, who perform certain activities as described in the Commerce Act. The latter are persons who are not involved in merchant activities but who can act as pledgors as referred to in the Law on Registered Pledges.[6]

The subject of contract in a pledge agreement is the agreement between the creditor and a debtor or a third party that the pledgee's / creditor's claim against pledged property has precedence over other creditors' claims whenever the claim is not willfully and adequately satisfied.

[6] It is most probably that this article of the Law on Registered Pledges will be changed with the introduction of copyrights, patents and so on as a possible pledged property (See "Forthcoming amendments to the Law on Registered Pledges" in this document).

Registered Pledge on Accounts Receivable

The law on registered pledges provides for a number of special types of pledges. In the case of a pledge of an account receivable there are two details of particular importance.

1) A pledge is effective against the debtor under the account, only after the debtor under the account has received a notice of it.

Either the pledgor or the pledgee can give the notice. It must contain at least the following items, which are required by the law: a statement that the account has been pledged, a description of the account receivable and of the part thereof that has been pledged as well as the facts contained in the Central Pledge Registry regarding the pledge.

The law does not specifically state the form of the notification. Since specific legal facts are required the notification must be presented in written form.

Neither is the law specific about the means to establish a certified date of the registered pledge.

A certified date is not required when recording a pledge in the Central Pledge Registry. Rather, it's assumed that from the date of recording in the Registry, it becomes known to third parties. Therefore the date of recording in the Central Pledge Registry is also accepted as the certified date for creating/ establishing the pledge. From this date on the pledge is perfected as against third parties.

2) The second important point is related to the right of the pledgor to collect the pledged account receivable until a notification for the start of an execution procedure is received, in which case the security rights granted (by the pledge) extend to the interest earned on the pledged account receivable.

The above implies that the share of the pledged account receivable collected by the pledgor prior to the execution notice remains pledged as a security for the pledged account receivable/ (right of the pledgee).

Of particular interest are the procedures of executing a transaction on pledged account receivable. This can be done either by the sale of the account receivable by means of a transfer of receivables against payment or by acquisition/collection of the account receivable if it is a monetary receivable, inventory, securities, etc.

In the first instance the pledgor transfers the pledged account receivable pursuant to the Obligations and Contracts Act[7] to a third party upon payment of its price (Articles 99 and 100). A common practice is to execute a transfer of receivables against payment in order to discount the account receivable (discount deal). The new owner is now in the position of a pledgor for the pledged account receivable.

In the case of default on the registered pledge the pledgee can satisfy its claim either from the price of the pledged account receivable, obtained through the discount deal with the original pledgee or by forcible collection on the pledged account receivable from the current pledgor.

In the second case the pledged account receivable is defined in generic terms.

If the pledge is a monetary receivable or proceeds from transactions to dispose of inventory in order to obtain other property, the pledgee can satisfy its claim in several ways. The claim can be satisfied either directly from the proceeds from the transaction or from the initiator of the transaction who, having received payment from the pledged receivable has become a pledgor.

If the proceeds from the transaction cannot be set as an item of property owned by the pledgor, the pledgee can satisfy its claim through any part the pledgor's property, equivalent to the value of the claim.

Pledge on entity shares in general and limited partnerships, limited partnerships with shares or limited liability companies

Besides to the requirement that a pledge agreement must be executed in writing, which is common for all types of special pledges, the law states that all signatures on an agreement that pledges a share of equity in a commercial company must be notarized.

Furthermore, all facts required by the Registered Pledges Law to register the agreement are also added to the record of the issuing company in the Commercial Registry. The date

[7] Article 99. A creditor may transfer his claim unless the law, the contract or the nature of the claim do not permit this.
A transferred claim shall pass on to the new creditor with its privileges, securities and other attributes, including interest arrears, unless otherwise agreed upon.
The former creditor must notify the debtor of the transfer and hand over to the new creditor any documents he may hold which verify the claim, as well as a confirmation in writing that the transfer has taken place.
A transfer shall be binding upon third parties and the debtor from the date when the latter is notified by the former creditor.
Article 100. If a transfer is for consideration, the creditor shall be liable for the existence of the claim at the time of the transfer.
He shall not be liable for the debtor's solvency, unless he has assumed such an obligation and then only up to the amount received for the transferred claim.

of recording of the agreement in the Central Pledge Registry is accepted as the certified date for creating/establishing the pledge.

Pledge on groups of accounts receivable, of machines and equipment, of inventory or materials

There are three types of groups to be pledged, based on the manner in which a group is formed:

- Pledge of a group that emerged from the processing or becoming part of other pledged property.
- Pledge of a group, whose components were part of the group at the time of creation of the pledge.
- Pledge of a group of uncertified securities and account receivables.

In the first instance the pledge is on a group, formed as a result of the processing or becoming part of pledged property together with property that hasn't been pledged; all security rights associated with the pledged property attach to the newly formed item.

There is a limit to the rights of the pledgor to dispose of the pledged group through legal transactions:

A) When subject of the transactions are uncertified securities (subject of pledge criteria)

B) When subject of the legal transactions are chattel and rights not in the ordinary course of business of the pledgor (pledgor's occupation criteria)

The consent of the pledgee is required in these instances; any transaction conducted without pledgee's consent is deemed null.

In practice the Law on Registered Pledges governs the pledge on newly formed groups. The law also differentiates between two types of pledged property, formed as a result of processing or becoming a part of other property:

A) Pledged property that is permanently attached to and inseparable from the group. As a result ownership of the pledged property cannot be transferred separately from ownership of the group.

B) If the pledged property is separable from the group, it can be disposed of through individual legal transactions.

Only the first type of pledged property can be used to establish a pledge on a group pursuant to the Law on Registered Pledges.

A pledge on a group (whose components were part of the group at the time of creation of the pledge) attaches to each one of its component, until the pledge is assigned to one or more specific components.

To separate a specific component from a pledged group is only possible if the pledgor effects its right to use the pledged property in its activity in accordance with its intended use.

In addition to the above-mentioned restrictions, the Law on Registered Pledges details a number of requirements pertaining to the pledge on groups of uncertified securities and accounts receivable. A group of accounts receivable may contain both existing and future accounts receivable, and can be described in either specific or generic terms. The creditor of the different types of accounts receivable is the pledgor. The rules governing the pledge of an account receivable also apply to the pledge on a group of accounts receivable.

The pledge of a group of accounts receivable is effective against debtors under the accounts only after they have been notified of the pledge (at the time of its creation) by the pledgor or the pledgee.

A group of uncertified securities may contain any type of securities issued as uncertified by the issuing company.

Such a group of uncertified securities is commonly known as a portfolio. Investment in securities that differ in type, issue, issuing company, face value and denomination is known as portfolio investment.

From the above it can be concluded that a group of uncertified securities represents a group of transferable rights of ownership.

The general rules and regulations that govern pledges on a group as well as the specific regulations that apply to pledges of uncertified securities also apply to pledges on a group of uncertified securities.

Legal transactions to dispose of uncertified securities take place only with the written consent of the pledgee.

Pledge on a commercial enterprise

An agreement for the pledge of a commercial enterprise must be executed in writing and all signatures on the agreement must be notarized.

Any facts required by Registered Pledges Law to be filled to record a pledge of a commercial enterprise must also be recorded in the pledgor's record in the Commercial Registry. A provision of this law states that the pledge is perfected as against third parties from the date of recording the pledge in the pledgor's record in the Commercial Registry, rather than from the date of execution or notarization of the pledge agreement.

Effectively the pledge of a commercial enterprise is a pledge of all assets owned by the enterprise.

There's a subtle difference in the definitions of a group in the Law on Registered Pledges and the Commerce Act. According to the Law on Registered Pledges a group comprises of accounts receivable, machines and equipment, inventory or materials and uncertified securities, i.e. assets or rights only. The Commerce Act definition is of a group of rights, obligations and factual relations, which includes the liabilities and obligations of the commercial enterprise. In the case of execution the pledgee (or a third party) may choose to either sell the individual assets of the enterprise, or to satisfy the claim from the commercial enterprise as a group, and is therefore accountable for its liabilities.

Introducing the registered pledge and its relation to increasing credit volumes

The introduction of registered pledges as a collateral is just one of the many factors that have contributed to the increase in the total amount of credits given out to private companies in Bulgaria; nevertheless a significant part of the growth in this field is due to/as a result of the Law on Registered Pledges.

This law does not establish a substitute for the existing types of securities; the registered pledge is yet another form of providing security for a credit that often grants larger credit amounts to the pledgee.

According to experts in the field only a small number of borrowers use registered pledges as the only means to secure a credit. Nevertheless, the use of registered pledges is the most common form of securing a credit when combined with other types of securities, i.e. mortgage on a real estate property of the owner or partners in a private company, (which

has proved to be a very strong incentive for borrowers to repay their debt). According to interviewed experts, the share of usage of specific pledges as a partial collateral for securing credits is above 80%.

Normally a credit secured with a mortgage on a piece of real estate owned by a company (workshop, store, hotel, etc.) is accompanied by a registered pledge on the equipment hosted in it. This makes it easier to effect the rights on the pledged security (including executing a transfer of receivables on the pledged security).

Inventory or other property purchased with a credit that facilitates the cash flow and operations of a private company are pledged pursuant to the Law on Registered Pledges, in addition to the other means used to secure the credit.

The above considerations provide an indirect means of evaluating the positive effect from the Law on Registered Pledges on the credit market in Bulgaria. Still, it can be concluded that the growth in credit volumes is directly related to, and largely as a result of this new law and the emergence of registered pledges as a preferred type of credit security.

Central Pledges Registry

The Central Pledges Registry at the Ministry of Justice is created with the Law on Registered Pledges, published in State Gazette, issue 100 from 22.11.1996, in effect from 01.04.1997 and amended in issue 86 of 1997, in effect from 30. 09.1997, issue 42 of 1999. It has been established as a judicial person with its seat in Sofia and is financed from a budget account. The law on Registered Pledges does not contain any rules and regulations with regard to the structure and the management of the Central Pledges Registry.

Activities of its administration are regulated with the Regulation on the Structure and Activity of the Central Pledges Registry, amended in State Gazette issue 27 from 01.04.1997 amended in issue 128 of 1998 amended in issue 49 of 2000.

The creation of the registry brings about practical opportunities for providing collateral for credits to all economic entities in the conditions of a market economy, which will contribute to their economic initiatives as well as for attracting investment.

In this sense the Central Pledges Registry is a part of a complex structural reform whose goal is to create stable guarantees for credit institutions.

The operation of the registry consists of four basic activities:

1) recording of registered pledges, lease contracts and contracts for sale with retention of title until payment of the purchase price

2) search for records of issued certificates or for the existence /absence of recorded facts

3) issuing of certificates for existence or absence of recorded facts

4) collection of state fees for the above three activities;

The Central Registry is administered by a Director appointed by the Minister of Justice. The registry is open to members of the public as required by law. Any person may obtain references or a certificate for existence or absence of recorded facts. The legal and administrative service to the public and the judicial persons listed on the register is provided by the “Central register office and local register bureaus”.

Local register bureaus have been established in Sofia, Plovdiv, Pleven, Varna, Blagoevgrad, Bourgas and Vratza.

The procedure of recording is protective by its nature and is performed in accordance with the requirements of the Regulations on the Structure and Activity of the Central Pledge Registry and is based on eleven types of forms of requests for recording, approved by the Minister of Justice. All forms of requests are published on the web site of the Central Pledge Registry.

Table 4 represents the real number of activities performed by the Central Pledge Registry for the years of its operation. It is very important to note that the interest of companies to use the specific pledge when securing a credit is growing steadily, which is directly visible if we compare the number of entries for the first year of operation of the Registry - a total of 2 357 entries to the number for the first half of 2002 - 12 370 entries.

Table 4. Activity of the Central Pledge Registry, (April 1997 – September 2002)

Type of entry in the Registry	Number of entries
Pledges	60 020
Sales	100
Lease	1256
Executions	1585
Terminations	14 313

Problems encountered by commercial banks in the crediting process

The demand for credits is related to the general state of economic and technological development of the economic entities in the country.

Investment credits have become a priority with the need for financing start-up businesses, for renovation of outdated production equipment in privatized companies, for improving in the quality of products and for boosting competitiveness of existing enterprises.

On the other hand, the technologically outdated and aging equipment of most enterprises is not an adequate security for long-term credits.

Another obstacle, that further limits access to bank loans is the disproportionately high weight placed on the value of the security demanded by the creditor as opposed to the projected income, the debt repayment resources, the good management as well as other favourable features of the borrowing company.

Even commercial banks find the Law on Banks far too restrictive. This law, a legacy from the austere macroeconomic environment of the past, needs to be changed to match the present stability of the banking system as well as to conform to other existing laws and regulations.

Representatives of banking institutions normally explain the behaviour of banks with the legislation, which at present regulates their activities. In this sense the lack of free credit resources is by far not the main obstacle for the development of the Bulgarian credit market. For example, according to Regulation 9 of the Bulgarian National Bank a mortgage of real estate in a residential property on behalf of a bank is treated more favourably than industrial estates, equipment and machinery, etc., which most Bulgarian companies can readily pledge as provisions for a loan.

Since provisions are put down as expenditures on a bank's balance sheet this deteriorates its financial results. That's why a bank would normally avoid taking up provisions in order to improve its financial results.

Until recently a major problem for credit institutions was the criminal liability of bank officials who grant unsecured credits. The more flexible approach to the requirement that the total credit amount is protected by a specific form of security by the Law on Banks contradicted with the more restrictive requirements of the Penal Code (Article 220,

Paragraph 3). This inconsistency has been resolved with the latest amendments in the Penal Code and the negative effects arising from it will no longer affect banks' credit activities.

Frequent changes in tax and tariff legislation further complicate and have an adverse effect on the processes of debt repayment and debt collection. This has a negative impact not only on the liquidity of collateral but also on the rate of collection of taxes and tariffs (public claims).

Due to the fact that the state takes precedence over all other types of creditors, any existing public claims against a company prevent it from obtaining new credit.

The period of disposal of pledged property is often too long, especially when the debtor challenges the rights of the creditor in court case that lasts for years.

Currently there is no developed secondary market for collateral in Bulgaria, while procedures for the execution on pledged property are generally slow and ineffective.

The ban on the sale and pledge of assets of newly privatized companies for a period of ten years is yet another obstacle to the credit system (it exists in privatization deals that involve a number of post-privatization obligations for the buyers, e.g. deferred payment for a given period, payment of acquired debt and the completion of an investment plan).

Although for most deals this ban is conditional, pledging assets above a certain percentage, as agreed on in the privatization contract, always requires the authorization of the privatizing agency.

Tangible fixed assets are considered to be a high-risk credit security because of their low liquidity – they are always harder to sell off and tend to depreciate more rapidly in value than most other assets.

Most private enterprises own predominantly technologically outdated and aging machinery and equipment, which can't be used as security for a credit. Even the Law on Accounting allows for a five-year period of full depreciation of machinery and equipment. That is why no more than 50-60 per cent of their market value at the time of granting the credit is accepted as collateral.

On many occasions the inventory isn't accepted as a reliable collateral, instead it's often considered to be old stock that is hard to sell. Letters of credit are also rarely considered as a security because of the risk related to non-payment by either the buying or the selling

party due to possible failure to fulfill the terms of the letter of credit agreement (e.g. quantities, quality of the product, shipment and delivery deadlines, etc.)

The Central Pledge Registry does not contain information whether shares of equity in the company are pledged as a security, because the status of company shares is not among the facts recorded in the registry. Furthermore, commercial banks experience a number of difficulties in their effort to exercise control on the credit repayment process.

Banks that do not have credit lines with foreign financial institutions usually experience difficulties when granting long-term credits. The credit resources of such banks can be estimated only over a short period of time (no more than one year) because they operate with three-month to one-year deposits. The lack of long-term assets to be used as credit resources distorts their balance figures and they fail to meet the strict requirements set by the Bulgarian National Bank. According to them, the growth of a bank's credit portfolio increases the risk of its deterioration, which has a negative effect on the stability of the financial sector and the currency board and hence on the national economy.

Recently a positive trend is observed in the credit activities of Bulgarian banks. The total amount of credits granted to non-financial institutions and other clients has already exceeded the amount of funds deposited by the banks in foreign financial institutions. Bulgarian banks have begun restructuring of their assets largely due to the fall in interest rates on deposits. The solvency, the ability to generate income and the overall balance of incoming and outgoing cash flows have become the most important criteria for assessing the creditability of potential borrowers. Providing adequate security is no longer the main factor for granting a credit, rather it has become an additional guarantee or an alternative resource for credit repayment.

Forthcoming amendments to the Law on Registered Pledges

The purpose of the forthcoming amendments to the Law on Registered Pledges is to broaden the range of pledged properties as well as to achieve a better balance between the rights of the pledgor and the pledgee. The need for these changes arises from the experience accumulated by the registered pledges system over its five-year period of existence in Bulgaria as well as from the changes in global credit markets and the Bulgarian macroeconomic framework in particular. The modernization of the Law on Registered Pledges takes place in parallel with the amendment of the Civil Procedure Code, which provides the basis for a number of procedures used by the law.

In order to increase the range of pledged properties, the law-in-project will include pledge of rights on patents and copyrights, registered trademarks, industrial designs, integrated circuit topologies, and certificates of plant sorts and animal breeds. In legal terms the above-mentioned rights represent transferable property rights on a part of the property owned by a pledgor and most of the time they may be used as a part of a registered pledge. This amendment will require that the restriction whereby the pledgor is a merchant or a person, pursuant to Article 2 of the Commerce Act, does not apply. A registered pledge of this type will have to be recorded in the registers of the Patents Office of the Republic of Bulgaria.

An important change in the law that will further guarantee the rights of creditors is an amendment that will grant the pledgee the right to access all information relevant to the pledged property through public institutions and third parties, which is otherwise only available to the pledgor. At present the pledgee is often denied access to this type of information, which may be against its best interest.

Another necessary amendment will affect execution procedures and is expected to increase the effectiveness in satisfying claims from pledged property. It will require that the point in time from when the pledgee can dispose of the pledged property be expressly defined, which is the moment of registering the commencement of execution procedures. The idea behind this amendment is to prevent the dishonest pledgor from diverting and disposing of pledged property to avoid forcible execution. In addition the amendment further details instances when it is possible to suspend the execution. It is important to

establish the legal standing of the pledgee who has initiated execution since the Law on Registered Pledges addresses the Civil Procedure Code on this issue.

A new article concerning the execution of specific parts of the commercial enterprise will be introduced with the forthcoming amendments. It will deal with the selling of ships, aircraft and real estate when they are elements of the aggregate of the pledged commercial enterprise. Because of the great value of those items it is necessary that their treatment is separately defined in the law. The reason for this change is connected with the core principles of the Law on registered pledges - a fast and reliable way for exercising the rights of the pledgee over the pledged property.

Although the proposed amendments to the Law on registered pledges commented in the above paragraphs include most of the necessary improvement of the legal regime, there are still several problems that need improvement. Still the biggest challenge for Bulgarian credit markets is the lack of legal practice and the slow reaction of the court in the case of default of the debtor.

The expected amendments are surely a positive step in the development of the Bulgarian legal regime regulating the credit market, but they are not the most important things that need to be changed for the overall improvement of the system. Bulgaria lacks the experience and the history of a successful banking sector in a market economy, and those are factors that need a lot of time to overcome. The good news is that we are following the right path and the results of the banking sector for the past few years undoubtedly show this.

Basic principles to be used as a foundation of future amendments to the Law on Registered Pledges

Regardless of the projected forthcoming changes in the legal framework that constitutes the system for registered pledges in the Bulgarian legislation, it is most likely that in view of the constantly changing social and economic environment new amendments for the modernization of this framework will be needed in the future.

Several fundamental trends should be taken into account in order for this process to take place in a smooth and controlled manner. The most important of these are:

1. Range and complexity of the amendments

1.1. Legislative – amendments to the Law on Registered Pledges, the Civil Procedure Code, the Penal Code, the Commerce Act, the Law on Obligations and Contracts, and the related legal acts and regulations (including those by the Bulgarian National Bank that deal with the quality of pledged property)

1.1.1. A centralized registry must be used (besides all the other different types of registries that exist at present; these must be frequently updated with the latest relevant data and processed for short periods of time) and the access to it must be as easy and simple as possible;

1.1.2. Introducing criminal liability for disposal of pledged property without the prior consent of the creditor;

1.2. Administrative improvements – modernization of the technological base underlying the centralized registry system and improvement of the skill base of the registry officials;

2. Coordinating changes in the Bulgarian registered pledges system with the internationally accepted legal standards

2.1. Use of registered pledges must decrease the credit risk, which will boost lending activities

2.2. New legislation in any of the above-mentioned laws and regulations must provide for a cheap and most of all fast procedure for the establishment of a registered pledge, while at the same time the pledgor will be able to continue to use the pledged property (thus avoiding a ‘freeze’ of goods and inventory)

2.3. In the case of a default on debt repayments the pledgee must be able to unconditionally and promptly dispose of the pledged property in order to satisfy its claim with a priority over any of the remaining creditors.